

A PREVIEW OF THE EARNINGS SEASON

Jeremy Schwartz — Global Chief Investment Officer
07/14/2020

On last week's *Behind the Markets* podcast we spoke with David Trainer, CEO of New Constructs, about the upcoming earnings season and how his measure of core earnings compares to the standard measures of earnings reported.

Trainer's team recently published the piece "Don't Fret 2Q Earnings: This [S&P 500](#) Will Continue to Rise." Trainer highlights how an elevated level of write-downs, which occur when the fair value of an asset falls below its [balance sheet value](#), is distorting and increasing the [volatility](#) in reported earnings.

Trainer believes that S&P 500 reported earnings are understated relative to New Constructs' measure of core profitability. Specifically, according to New Constructs, core earnings for the S&P 500 over the last 12 months show a 2% fall since 2019, while consensus predicts a 22% fall.

While the S&P's operating earnings are less noisy than traditional [GAAP \(Generally Accepted Accounting Principles\)](#) earnings, there is still lower variability in the New Constructs Core Series going back over the last 15 years, particularly during the global financial crisis in 2009.

This quarter coming up will likely have the biggest distortions of this cycle, so it will be interesting to keep tabs on what the New Constructs data series looks like.

Figure 2: Core vs. SPGI's Operating Earnings for the S&P 500 – % Change: 2005 – Present



Sources: New Constructs, LLC, company filings, and S&P Global (SPGI).

Note: the most recent periods' data for SPGI's Operating Earnings is based on consensus.

Our Core Earnings analysis is based on aggregated quarterly data for the S&P 500 constituents in each measurement period.

One segment of the market that has been particularly impacted in both market performance and earnings deterioration in 2020 has been [small-cap](#) companies.

Kara Marciscano, Senior Analyst on our index team, discussed the trends in small-cap earnings on our podcast.

Small caps have more unprofitable companies than ever present; more than 20% of the [Russell 2000](#) is regularly unprofitable.

Marciscano looked at the higher-quality [S&P 600 Index](#)—which typically has significantly less exposure to unprofitable companies. But even S&P 600 GAAP earnings moved into negative territory in the trailing 12 months, driven by a large loss in Q1 2020 that offset earnings in the prior three quarters.

The 1Q 2020 loss presented by GAAP earnings would be one of the worst quarters for small-cap companies since the financial crisis—it is more than double the size of the GAAP loss in 4Q 2008. This upcoming earning season is apt to be even more negative, as Q1 only had a few weeks of economic shutdown, while Q2 was largely completely shut down.

To put the size of the 1Q 2020 GAAP loss into perspective, it was large enough to wipe out earnings over the preceding nine quarters, or more than two years' worth of earnings.

Adjusted measures of earnings paint a difficult, but not nearly as disastrous, quarter for small caps. Both S&P operating

earnings and New Constructs' core earnings indicated that small caps were profitable in the trailing 12 months.

Based on New Constructs' S&P 600 core earnings, which leverage cutting-edge technology to adjust reported earnings for unusual gains/losses buried in the footnotes of financial filings, Marciscano estimates small-cap core earnings decreased approximately 25% since the end of 2019 but are still in profitable territory.

S&P 600 EPS and Trailing P/E		
	EPS	P/E
GAAP	(\$30.96)	N/A
New Constructs Core	\$27.35	30.4x
S&P Operating	\$3.97	209.5x

Sources: WisdomTree, FactSet, S&P Global, as of 6/30/20. Weights subject to change.

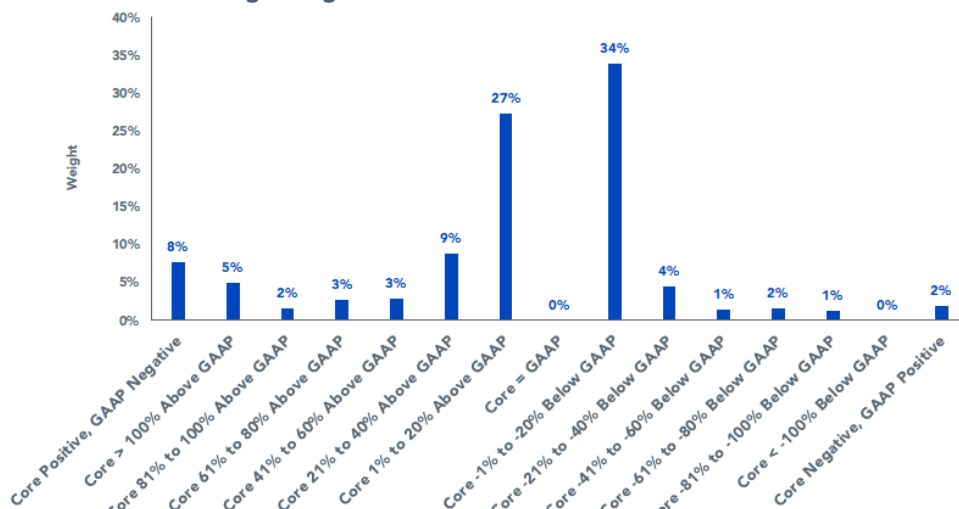
The difference between the GAAP and New Constructs' core earnings is a function of the direction and magnitude of adjustments that New Constructs makes to reported GAAP earnings.

Directionally, upward adjustments to S&P 600 earnings have occurred more frequently than downward adjustments over the last 12 months. Based on New Constructs' data, approximately 56% of the S&P 600 exposure had understated GAAP relative to their measure of core profitability, while the remaining 44% had GAAP earnings that were overstated.

Despite a roughly even split in the direction of adjustments, the magnitude of upward adjustments has been significantly larger than downward adjustments. New Constructs' earnings are at least 20% higher than GAAP earnings for about 20% of the S&P 600's exposure in the last 12 months. In addition, approximately 8% of the S&P 600 was profitable based on New Constructs' core earnings but unprofitable on a GAAP basis.

S&P 600 Exposure to Unprofitable Companies		
	Count	Weight
GAAP	186	18%
New Constructs Core	112	10%

Core vs. GAAP Earnings Weight Distribution



Sources: WisdomTree, FactSet, as of 6/30/20. Past performance is not indicative of future results. You cannot invest directly in an index. Weights subject to change.

Marciscano's analysis implies that the fall in small-cap earnings may be less severe than other measures of earnings have presented. Looking ahead, Marciscano emphasizes the importance of looking beyond reported measures of earnings to evaluate the pace of decline and eventual recovery in earnings, especially in this uncertain economic environment.

Please listen to our full podcast with Trainer on this upcoming earnings season below.

Behind the Markets on Wharton Business Radio · Behind The Markets Podcast: David Trainer

Unless otherwise stated, data sources are WisdomTree, FactSet and S&P Global, as of June 30, 2020.

For standardized performance and the most recent month-end performance click [here](#) NOTE, this material is intended for electronic use only. Individuals who intend to print and physically deliver to an investor must print the monthly performance report to accompany this blog.

For more investing insights, check out our [Economic & Market Outlook](#)

View the online version of this article [here](#).

IMPORTANT INFORMATION

U.S. investors only: Click [here](#) to obtain a WisdomTree ETF prospectus which contains investment objectives, risks, charges, expenses, and other information; read and consider carefully before investing.

There are risks involved with investing, including possible loss of principal. Foreign investing involves currency, political and economic risk. Funds focusing on a single country, sector and/or funds that emphasize investments in smaller companies may experience greater price volatility. Investments in emerging markets, currency, fixed income and alternative investments include additional risks. Please see prospectus for discussion of risks.

Past performance is not indicative of future results. This material contains the opinions of the author, which are subject to change, and should not to be considered or interpreted as a recommendation to participate in any particular trading strategy, or deemed to be an offer or sale of any investment product and it should not be relied on as such. There is no guarantee that any strategies discussed will work under all market conditions. This material represents an assessment of the market environment at a specific time and is not intended to be a forecast of future events or a guarantee of future results. This material should not be relied upon as research or investment advice regarding any security in particular. The user of this information assumes the entire risk of any use made of the information provided herein. Neither WisdomTree nor its affiliates, nor Foreside Fund Services, LLC, or its affiliates provide tax or legal advice. Investors seeking tax or legal advice should consult their tax or legal advisor. Unless expressly stated otherwise the opinions, interpretations or findings expressed herein do not necessarily represent the views of WisdomTree or any of its affiliates.

The MSCI information may only be used for your internal use, may not be reproduced or re-disseminated in any form and may not be used as a basis for or component of any financial instruments or products or indexes. None of the MSCI information is intended to constitute investment advice or a recommendation to make (or refrain from making) any kind of investment decision and may not be relied on as such. Historical data and analysis should not be taken as an indication or guarantee of any future performance analysis, forecast or prediction. The MSCI information is provided on an "as is" basis and the user of this information assumes the entire risk of any use made of this information. MSCI, each of its affiliates and each entity involved in compiling, computing or creating any MSCI information (collectively, the "MSCI Parties") expressly disclaims all warranties. With respect to this information, in no event shall any MSCI Party have any liability for any direct, indirect, special, incidental, punitive, consequential (including loss profits) or any other damages (www.msci.com)

Jonathan Steinberg, Jeremy Schwartz, Rick Harper, Christopher Gannatti, Bradley Krom, Tripp Zimmerman, Michael Barrer, Anita Rausch, Kevin Flanagan, Brendan Loftus, Joseph Tenaglia, Jeff Weniger, Matt Wagner, Alejandro Saltiel, Ryan Krystopowicz, Jianing Wu, and Brian Manby are registered representatives of Foreside Fund Services, LLC.

WisdomTree Funds are distributed by Foreside Fund Services, LLC, in the U.S. only.

You cannot invest directly in an index.

DEFINITIONS

Value : Characterized by lower price levels relative to fundamentals, such as earnings or dividends. Prices are lower because investors are less certain of the performance of these fundamentals in the future. This term is also related to the Value Factor, which associates these stock characteristics with excess returns vs the market over time.

Volatility : A measure of the dispersion of actual returns around a particular average level. .

Generally Accepted Accounting Principles (GAAP) : Principles of accounting utilized in the U.S. that deal with different aspects and assumptions that are deemed acceptable in calculating the earnings of a firm.

Small caps : new or relatively young companies that typically have a market capitalization between \$200 million to \$2 billion.

Russell 2000 Index : Measures the performance of the small-cap segment of the U.S. equity universe. The Russell 2000 is a subset of the Russell 3000 Index representing approximately 10% of the total market capitalization of that index. It includes approximately 2000 of the smallest securities based on a combination of their market cap and current index membership.